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IN THE

Supreme Court of the United States

DORIS STIEGLITZ WARD, individually
and on behalf of all others
similarly situated,

Petitioners,

v.

STATE OF SOUTH CAROLINA,

Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of South Carolina

PETITIONER'S REPLY BRIEF

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INTRODUCTION

South Carolina asserts that under the Tenth Amendment, it has an unfettered right to enact a statutory regime with the acknowledged purpose and effect of perpetuating unconstitutional discrimination in the taxation of federal employees. This holding, if permitted to stand, would make the intergovernmental tax immunity doctrine an empty formality—easily and openly evaded by any State committed to discriminating against federal employees. According to South Carolina, moreover, it has provided a "remedy" responsive to this Court's decision in *Davis* v. *Michigan Department of Treasury*, 489 U.S. 803 (1989), by enacting facially non-discriminatory taxation *and* a subsidy with the purpose and effect of compensating state employees for paying the same taxes that federal employees pay. The South Carolina court's decision does not comport with *Davis* and cannot be reconciled with *West Lynn Creamery, Inc.* v. *Healy*, 512 U.S. 186 (1994), where this Court found unconstitutional a state's non-discriminatory taxation of in-state and out-of-state producers, because the state also paid a subsidy to in-state producers with discriminatory intent and effect.

The question whether a state can evade the non-discrimination mandate of the intergovernmental tax immunity doctrine (and of the dormant Commerce Clause) by enacting subsidies for state employees (and in-state businesses) is important and recurring. It applies both to state statutes enacted in response to *Davis* and to any state statutory scheme enacted with the purpose and effect of discriminating against federal employees or interstate commerce. Equally to the point, there is presently a conflict among state courts on the question whether states can remedy discrimination that violates the intergovernmental tax immunity doctrine by enacting a facially neutral tax code and a linked compensation increase, with South Carolina and Virginia taking the position that states can always do so and Montana and Oregon taking

the opposite view. Tens of thousands of federal retirees' benefits are affected, with 65,000 at stake in South Carolina alone; other States' statutory responses to *Davis* are subject to challenge. The conflict and confusion in the lower courts about the application of the Constitution's non-discrimination mandates where facially neutral tax laws are linked to compensating pay increases and subsidies is worthy of this Court's attention.[1]

ARGUMENT

THE DECISION BELOW BROADENS A CONFLICT ABOUT *DAVIS* v. *MICHIGAN DEPARTMENT OF TREASURY* AND PRESENTS AN IMPORTANT, RECURRING CONSTITUTIONAL QUESTION.

1.(a) South Carolina concedes that "the General Assembly increased state employees' retirement benefits to compensate for the increased income tax obligations resulting from Act 189. Pet. App. 3a; Pet. 17. South Carolina nonetheless contends, and its supreme court agreed, that this linkage has *no* constitutional significance. South Carolina bases its position on (i) an expansive reading of the Tenth Amendment as providing the State with an absolute right to set employee compensation, and (ii) a parsimonious reading of *Davis* as concerned only with state laws labeled "taxation" and not those setting "compensation." Pet. App. 4a.

The South Carolina court's analysis is fundamentally at odds with this Court's repeated instruction that a State's label does not control the application of the intergovernmental tax immunity doctrine. See *Jefferson County, Ala.* v. *Acker*, 527

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[1] South Carolina insinuates that there may be a statute of limitations question in this case (Opp. 1 & n.2), but that is untrue. The State moved to dismiss on this ground below; the circuit court rejected the motion, and the State neither filed a cross-appeal from that ruling nor defended the circuit court's decision on that ground.

U.S. 423, 439 (1999) ("[t]he practical impact, not the State's name tag," determines whether a provision "fits within the Public Salary Tax Act's allowance"); *City of Detroit* v. *Murray Corp. of Am.*, 355 U.S. 489, 492 (1958) ("in determining whether the[] tax[] violate[s] the Government's constitutional immunity we must look through form and behind labels to substance."). Here, it is undisputed that in "substance," Act 189 is designed to allow South Carolina's retired employees to retain the benefit of the State's unconstitutional tax treatment of federal retirees. The decision under review directly presents the question whether the State's compensation decisions are immune from judicial scrutiny under the intergovernmental tax immunity doctrine in this setting.[2]

(b) In opposing this Court's review, South Carolina wrongly characterizes *West Lynn Creamery* as irrelevant. Opp. 19 n.9. In fact, this Court has expressly stated that the dormant commerce clause is "conceptually similar" to the intergovernmental tax immunity doctrine, 512 U.S. at 200 n.17, making plain the analogy between *West Lynn Creamery*'s linkage of premium payments and subsidies and South Carolina's linkage of its exemption repeal and retiree benefits increase. Like South Carolina, the respondent in *West Lynn Creamery* argued that because both components of its program—the subsidy and the nondiscriminatory tax—

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[2] South Carolina says that petitioners argue "that states are free to raise the benefits of their retirees as long as those increases do not coincide with the elimination of a tax exemption," Opp. 12 n.5, but they cite nothing to support this untrue statement. Petitioners have consistently argued that the State cannot increase retiree compensation with the intent and effect of compensating retirees for the loss of a discriminatory exemption. The simultaneity of a state's repeal of a discriminatory taxation scheme and enactment of a compensating benefit is clear evidence of linkage, *see* Dan T. Coenen & Walter Hellerstein, *Suspect Linkage: The Interplay of State Taxing and Spending Measures in the Application of Constitutional Antidiscrimination Rules*, 95 Mich. L. Rev. 2167, 2174 (1997); here the State's purpose to perpetuate past discrimination was conceded.

were individually valid, the program as a whole was valid. *Id.* at 198. This Court, however, made clear that it is error to "assum[e] that the constitutionality of [a state tax and benefit scheme] follows logically from the constitutionality of its component parts." *Id.* at 199.

The State utterly fails to distinguish *West Lynn Creamery*. It first resorts to the Tenth Amendment, Opp. 19 n.9, and contends that the federal government has no delegated power to interfere with how it compensates its employees. This argument is wrong,[3] and it also fails to distinguish the intergovernmental tax immunity doctrine from the dormant Commerce Clause. The State has the power to compensate its employees and subsidize its businesses, so long as it does not do so with the purpose and effect of discriminating against federal employees and out-of-state businesses. Thus, where, as here, the State's increase in retirees' "compensation" is in substance a discriminatory tax rebate, the State's power is circumscribed by the intergovernmental tax immunity doctrine. The South Carolina court's erroneous application of the Tenth Amendment in this case eviscerates the protections of the doctrine and leaves the State free to perpetuate discrimination against federal employees.

Nor is *West Lynn Creamery* distinguishable on the basis of the purportedly greater linkage between the nondiscriminatory tax and the compensating payment in that case. Initially, South Carolina's contention—that Act 189 differs from the scheme in *West Lynn Creamery* because individual state retirees' benefit increases are not always identical to their individual increased tax liabilities, Opp. 19 n.9—is wrong. As set forth in the Petition (17-18, 27), the State enacted a benefit increase that compensated individual

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[3] The Tenth Amendment does not preclude federal regulation of the compensation of State employees. *See, e.g., Garcia* v. *San Antonio Metro. Transit Auth.*, 469 U.S. 528 (1985) (subjecting State compensation of employees to the Fair Labor Standards Act).

retirees as closely as possible for the loss of the unconstitutional tax preference. In addition, *West Lynn Creamery* turned on the intertwined nature of the tax and the subsidy and the scheme's discriminatory purpose and effect, declining "to analyze separately two parts of an integrated regulation." 512 U.S. at 201. The court below, in significant contrast, treated the intertwined provisions of Act 189 as separate measures and thus constitutional *as a matter of law*.[4]

(c) South Carolina characterizes petitioners' reading of *Davis* as one mandating equality of take-home pay for federal and state government retirees. Opp. 13-14. This is a straw man. Petitioners freely acknowledge the State's authority to set employees' compensation, but that authority is limited by the Constitution which forbids States to perpetuate an unconstitutional tax preference for state retirees.

Moreover, it is unknown whether South Carolina's federal retirees would pay the same taxes they now pay had the State complied with *Davis*. The alternative remedies this Court established in *Davis* achieve their remedial effect only if States make the hard political choice of giving up tax revenues from federal retirees or increasing the tax liability of state retirees. Pet. 19-20.

> [W]hen a nondiscriminatory tax is coupled with a subsidy to one of the groups hurt by the tax, a State's political processes can no longer be relied upon to prevent legislative abuse, because one of the in-state interests which would otherwise lobby against the tax

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[4] South Carolina also makes a puzzling reference to the benefits federal retirees may receive by residing in and paying income tax to the State to distinguish this case and *West Lynn Creamery*. Opp. 19 n.9. The Court, however, gave no indication that the benefits out-of-state milk producers received because they paid the State's assessment (*e.g.*, the right to do business in the State) were relevant to whether the Massachusetts scheme was constitutional. Any benefits resulting from the retirees' residence in South Carolina are similarly irrelevant to the constitutional analysis here.

> has been mollified by the subsidy. [*W. Lynn Creamery*, 512 U.S. at 200.]

The State cannot say that federal retirees would have paid the same state taxes absent its constitutional violation, because it does not know what result would have emerged from a political process responsive to the Court's mandate in *Davis*.

(d) South Carolina also defends its actions as authorized by a footnote in *Davis*, citing 489 U.S. at 815 n.4. Opp. 15-16. Initially, the question whether the State could perpetuate its discriminatory treatment by compensating state retirees for increased tax liabilities was not, of course, before the Court. Second, the footnote was not addressed to the State's power to compensate employees, but to the dissent's argument that "it [was] peculiarly inappropriate to focus solely on the treatment of state governmental employees" (rather than all state citizens) in finding discrimination against federal employees. 489 U.S. at 824 (Stevens, J., dissenting). Last, if South Carolina's aggressive reading of the *Davis* footnote were correct, a State could increase a retiree's benefits in an amount identical to the retiree's additional taxes, nullifying *Davis*' mandate of equal treatment. Oregon and Montana have already *rejected* any such reading of *Davis*.

This Court should grant review of South Carolina's announcement of a rule of law authorizing the facile evasion of the intergovernmental tax immunity doctrine set forth in *Davis* and the State's perpetuation of its discriminatory tax treatment of federal employees and retirees.

2. South Carolina is manifestly wrong in stating that the decision below does not conflict with the decisions in *Sheehy* v. *Public Employees Retirement Division*, 864 P.2d 762 (Mont. 1993), and *Vogl* v. *Department of Revenue*, 960 P.2d 373 (Or. 1998). Opp. 20. The South Carolina Supreme Court held that the State's increase in its employees' compensation can never be an unconstitutional tax rebate because the State has a Tenth Amendment right to determine state employees'

compensation and any restriction on that compensation authority would "violate[] the Tenth Amendment" and impair "state sovereignty." Pet. App. 3a-4a. This is true, the court opined, "even if the state's purpose is to compensate its employees for the loss of the income tax exemption." *Id.* at 5a.

Sheehy and *Vogl* reject South Carolina's determination that a state's compensation decisions are immune from constitutional scrutiny. In both cases, the state supreme courts held that the States' repeal of the state employees' tax exemptions and the increases in state employees' retirement benefits were linked; that the linkage was "intended to make up, in part for that [tax] equalization"; and that "the adjustment is a partial tax rebate denominated otherwise in an attempt to evade the requirements of federal law." *Sheehy*, 864 P.2d at 768. See also *Vogl*, 960 P.2d at 379, 380 (a benefits increase intended and designed to "'make up' for lost net income" is in "substance" an unconstitutional tax rebate).

South Carolina tries to argue that the different results in these cases can be explained by the differences in the statutory schemes, but this is clearly incorrect. First, the holding below is that a state compensation increase can *never* violate the intergovernmental tax immunity doctrine because the State has a Tenth Amendment right to make these decisions unrestricted by other constitutional provisions. *Sheehy* and *Vogl* plainly conflict with that holding.

Second, South Carolina cites differences between the coverage and amount of the increases in its scheme and in the schemes enacted by Montana and Oregon. Opp. 22-24. It is South Carolina's legal holding and not these minor differences that explains the differing outcomes in these States. Moreover, the critical difference South Carolina relies on—the alleged lack of mathematical correlation between the increase in taxes and the increase in compensation—is wrong. In *Vogl*, as here, the State granted all state retirees an increase in compensation based on the maximum state tax rate; thus,

the tax and compensation increases were as closely correlated as possible, but not perfectly correlated (indeed, the latter is virtually impossible to achieve). See 960 P.2d at 380 (explaining that the 1995 statute "does not purport to offset, dollar for dollar, the amount lost to the exemption repeal in every individual case"); Pet. 17-18 (demonstrating that although not dollar-for-dollar, South Carolina endeavored to match the tax and compensation increases as best it could).

Much more critically, in *Sheehy* and *Vogl*, the coverage (the group of state employees receiving the compensation increases) and the amount of the state-awarded increases are simply *evidence* that the respective State's intent and effect was to perpetuate discrimination against federal employees. Such evidence was particularly critical in Montana where the State did not acknowledge that its intent was to compensate state employees for the loss of their discriminatorily favorable tax treatment. See *Sheehy*, 864 P.2d at 768 (amassing pieces of evidence demonstrating legislature's discriminatory intent). Here, as was true in Oregon (see *Vogl*, 960 P.2d at 380), the State's intent to perpetuate its discrimination in favor of state employees was open and acknowledged, and the rebate achieved that intent. See Pet. App. 3a (acknowledging that South Carolina increased retirement benefits to compensate state retirees for the increased income tax obligations imposed in Act 189); see also Pet. 17 (quoting lower court decisions). The minor differences among the state schemes cannot explain the diametrically opposed conclusions that the state courts reached on the constitutionality of linked tax and compensation increases in response to *Davis*.[5] Had the South

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[5] Thus, South Carolina is simply wrong when it says that petitioners are attacking the lower court's factual finding of no "dollar-for-dollar" correlation, Opp. 21. Dollar-for-dollar correlation is not required; and, like Oregon in *Vogl*, the State here sought to compensate its retirees as closely as possible for the tax increases. Most critically, correlation is evidence of the State's intent and design to perpetuate discrimination,

Carolina scheme been reviewed in Oregon or Montana, it would have been struck down as unconstitutional.

3. Despite South Carolina's characterization, Opp. 25, its highest court's evisceration of the intergovernmental tax immunity doctrine by announcing the State's absolute Tenth Amendment right to set employee compensation is hardly inconsequential. This case is critically important because it poses both the specific question of the enforcement of the Court's mandate in *Davis*—a question that has now generated a conflict among the states—and the more general question of the meaning of the federal Constitution's prohibition of state discrimination in taxation of federal employees and of interstate commerce.

With respect to *Davis* specifically, this case alone involves approximately 65,000 federal retirees. Thousands of other federal retirees are involved in litigation in Utah and potentially in Arizona. The constitutional treatment of tens of thousands of retired federal employees is important by itself; here that importance is compounded by several additional factors.

First, South Carolina's decision—that it has an absolute right under the Tenth Amendment simultaneously to increase taxes and compensate state retirees and employees for such tax increases—does not apply only to the specific linked scheme at issue here. Under the analysis in this decision, South Carolina and any state seeking to provide favored tax treatment to its own employees may use this technique to avoid the command of the intergovernmental tax immunity

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which were confirmed here by the State's admission and the court's statements (cited at Pet. 17-18).

Nor do we advance a strict rule of simultaneity, as the State suggests. Opp. 12 n.5. While the simultaneous enactment of both provisions of Act 189 is a powerful factor that contributes to finding a linkage between them—and thus calling for constitutional analysis of Act 189 as a whole—simultaneity is but one more piece of evidence, *see* n.2 *supra*.

doctrine in the future. See Pet. 25. And, as demonstrated in the Petition, the decision below is relevant to dormant Commerce Clause challenges to facially neutral state tax laws linked to subsidies of in-state industries.

Moreover, this case represents the remedial phase of the Court's decision in *Davis*. South Carolina has attempted to evade the Court's mandate by enacting linked statutes with the acknowledged purpose of perpetuating state retirees' favored status; other States have refused to allow similar attempts to circumvent the substantive impact of this Court's finding of discrimination in *Davis*. This case thus involves the enforcement of this Court's mandate uniformly among the states—a question whose importance transcends that of the merits of the individual case.

Whether assessed in terms of the number of federal retirees and employees affected now and in the future, or in terms of the importance of maintaining the integrity of the intergovernmental tax immunity doctrine or dormant Commerce Clause jurisprudence, or in terms of resolving a conflict among state courts about the constitutionality of linked tax and compensation/subsidy schemes, this case merits the Court's attention.

CONCLUSION

The petition for certiorari should be granted.

Respectfully submitted,

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